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Underreported Taxable Income: The Problem and Possible Solutions

Federal Taxation Division

JANUARY 1983

This study was adopted in July 1982 and, thus, does not consider the tax law changes effected by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Tax Policy Subcommittee

December 1982

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Federal Taxation Division

JANUARY 1983

AICPA American Institute of Certified Public Accountants
1620 Eye Street, N.W., Washington, D.C. 20006

FOREWORD

In late 1979, the AICPA Federal Tax Division formed a task force, under the direction of the Tax Policy Subcommittee, to study the problems of tax revenue losses due to underreported income. The objective was to consider the various problems and issues and to present recommendations for possible approaches to improve reporting of income. This report embodies the results of the task force study.

It is now widely recognized that loss of tax revenue from underreported income (also referred to as the compliance gap, the underground economy, the hidden economy) is a major problem in the tax system. The so-called tax gap is enormous by anyone's estimate and is growing larger. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) includes many measures aimed at reducing this revenue loss. Some of the possible solutions discussed in this study have been adopted in TEFRA; others have not. This study is offered as a contribution to the ongoing debate about the problem of underreported income.

Over two years of dedicated work went into the development of this study, and the members of the task force —

Donald H. Skadden, Chairman

John Gilbert

Donald M. Tannenbaum

Rufus Hardy

have earned the appreciation of the AICPA Federal Tax Division. Mr. Skadden's tireless efforts, in particular, were instrumental in

completing the study. The recommendations presented have been approved by the Tax Policy Subcommittee and the Executive Committee of the AICPA federal tax division. The members of these bodies in 1982, when the report was approved, were:

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INTRODUCTION

The intentional underpayment of taxes is certainly not a new phenomenon. It has been a common problem since biblical times. The scope and magnitude of the problem have varied from time to time and from country to country, but underpayment has been a serious concern for centuries. The citizens' attitudes and their inclination to underpay can vary from one type of tax to another. For example, within the United States the high level of noncompliance with the personal property tax has caused many jurisdictions either to abolish or modify that system; however, during this same time span there has been a high degree of voluntary compliance with the self-assessed income tax.

Since World War II, however, voluntary compliance in the United States has deteriorated, and during the past ten or fifteen years this unfortunate development has reached serious proportions. Various studies indicate that the federal tax shortfall due to the underreporting of income may be as high as \$70 billion to \$120 billion. If such amounts were collected in full, the federal budget could be balanced and/or tax rates could be decreased significantly. This situation presents a serious equity issue: The honest taxpayers are bearing an ever-increasing burden because of the growing number of citizens who are not paying their full tax. This can easily become a self-perpetuating cycle. As the honest taxpayers' burden increases, the growing inequity of the situation may convince them that they are

paying an unfair share. This, in turn, could motivate more of them to join that segment of society that is not paying what the law requires, and might ultimately lead to the breakdown of the voluntary compliance system itself.

In addition, if the situation continues to worsen, it could lead to the disruption of our economy and even to a breakdown in society if Congress finds itself unable to raise sufficient revenue. In all likelihood, if the situation threatens to approach such proportions, Congress will feel compelled to adopt a system quite different from the self-assessment system we have enjoyed for so many years.

The Federal Tax Division of the American Institute of CPAs has recognized that CPAs have valid reasons to be concerned about this situation. Accountants are concerned with the growing inequities among citizens and have a professional interest in maintaining the viability of the voluntary compliance system.

This report addresses the terminology and scope of the problem, the nature of underground income, possible causes of underreporting, the situation abroad, public opinion, and possible ways to alleviate the problem. An extensive bibliography and a list of references include citations to significant articles, books, and special studies related to the underground economy. The parenthetical numbers in the text refer to the corresponding items in the list of references.

SUMMARY OF RECOMMENDED ACTIONS

While it is recognized that underreporting of income will never be completely cured, this report suggests several specific actions that could help alleviate the inequities and contain the growth of the underground economy. The areas of concern, types of recommendations, and some of the specific suggestions are outlined below.

Enforcement activities

- o The IRS should redirect some of its efforts toward the underground economy.

Penalties

- o Current penalties for both civil and criminal fraud should be reexamined.

Informational reporting

- o Reporting should be extended to include business payments to corporations, transactions with barter exchanges, auction houses, dealers in collectibles, and large currency transactions.
- o Tax returns should be modified to provide more information and to ease matching with informational forms.

Withholding should be required on —

- o Business payments to independent contractors.
- o Interest and dividend payments. (The government should bear the administrative burden or the cost thereof.)

- o Taxable pension payments.
- o State tax refunds.

Currency reform

- o Encouraging the use of checks and credit cards and discouraging the use of currency might deter transactions that are common to certain facets of the underground economy.

Tip income

- o A special conference should be held to explore new and innovative approaches to this perplexing problem area.

Education programs

- o It is probable that some taxpayers underreport income because they do not understand that —
 - The income is taxable.
 - The risk they are running by underreporting is significant.
 - Their actions have consequences for the economy and the country.
- o The IRS should expand and improve its educational efforts.
- o Some educational efforts would have greater credibility and acceptance if provided by groups outside the government.

Therefore, the AICPA should seek to enlist the support of other organizations in an effort to conduct an extensive national education program.

TERMINOLOGY AND SCOPE OF THE PROBLEM

Several labels have been coined for that part of the economy that consists of income concealed from the tax collectors. The most common seems to be "underground economy"; authors have also used "subterranean," "clandestine," "irregular," and "hidden" economy. The Internal Revenue Service has subdivided the area into the "illegal economy" and the "informal economy." Illegal describes the underlying transactions and includes prostitution, gambling, drugs, extortion, embezzlement, and the like. In the informal economy, the activities are legal but are not reported properly, or not reported at all, for tax purposes.

The charge to the Task Force was to examine only the informal segment of the underground economy to determine how the accounting profession could assist in alleviating the problem and what additional measures the government or others could take to improve compliance with the income tax statutes.

We have not attempted to measure the dollar volume of the underground economy. The several studies that undertook that task have shown widely varying results, but all of them indicate that the problem is serious enough to deserve the attention of CPAs and other responsible citizens.

The earliest relevant study was reported in 1977 by Peter M. Gutmann, an economist from Baruch College of the City University of New York (11, 12, 13). He estimated that approximately \$176 billion in income was going unreported in 1976, approximately one third of it from illegal activities and the other two thirds from the informal

economy. Gutmann's estimates were based on an examination of the stock of money (M1), composed of currency plus demand deposits. Gutmann stated that from 1937 to 1941 the underground economy was small. Using that base period, he found that currency averaged \$217 per \$1,000 of demand deposits. Gutmann then determined that by 1976 currency in circulation had reached \$344 per \$1,000 of demand deposits (an increase of \$127 per \$1,000, or 36.9 percent). Gutmann therefore inferred that of the \$77.8 billion in circulation in 1976, 36.9 percent, or \$28.77 billion, was used to fund the underground economy. The other \$49.1 billion of currency in circulation, plus the \$226.2 billion of demand deposits, made up the total money supply in the regular, reported economy. The total money supply of \$304 billion supported a GNP of \$1,869 billion. Gutmann therefore concluded that the \$28.7 billion was supporting an unreported economy of \$176 billion.

Gutmann noted that currency held abroad, or used to store ill-gotten wealth, is not subtracted before estimating the unreported GNP. Furthermore, on the basis of the \$176 billion generated in the underground economy, Gutmann estimated that up to 1.6 million more workers may have been employed than were reflected in official statistics. In a later study, he revised this estimate to 5 to 6 million workers who are employed only in the underground economy (10).

In 1978 Edgar L. Feige, an economist from the University of Wisconsin, estimated the underground economy at \$400 billion (7, 8). Feige questioned Gutmann's assumptions relating to the base period chosen, an unchanging ratio of currency to demand deposits, the use of

currency as the exclusive medium of exchange in the underground economy, and the same amount of GNP generated by reported and unreported dollars. Instead, Feige used the sum of all transactions to estimate total macroeconomic activity. The ratio of total transactions (using the estimated life of circulating currency) to observed income was determined. The ratio for the benchmark year, 1939, was used to estimate GNP without an underground economy. The difference between the estimated and actual GNP produced Feige's approximations of the underground economy.

As with Gutmann, some of Feige's assumptions are questionable: the choice of an appropriate base year, the assumed nonexistence of an underground economy in 1939, the relative income velocity in the irregular and regular economies, the estimates of turnover rates of demand deposits and currency, and the exclusion of barter transactions from the estimates.

Gutmann and Feige used entirely different methodologies, yet each estimated that the underground economy was growing two or three times faster than the regular economy. Both men revised their estimates in 1981, raising them to \$420 billion and \$800 billion, respectively. These estimates suggest that as much as 10 to 25 percent of GNP may be unreported.

Moreover, since these amounts are excluded from national income statistics, it is apparent that many of the widely followed macroeconomic measurements are erroneous, and the judgements based thereon may be misleading. Such measurements as national income, GNP, unemployment, and inflation are seriously misstated, because they do not take into

consideration the underground economy. Yet many government and business decisions are based upon those numbers, including the automatic indexation of social security benefits, many wage contracts, changes in the money supply, and various social programs.

In 1979, the IRS published the results of a special study of 1976 incomes (14). The IRS estimated that individuals had failed to report approximately \$135 billion of income in 1976. Of this, about \$100 billion was income from legal sources, which should have produced some \$17 billion of income tax. The report, quite appropriately, pointed out that during the same year individuals did report \$1.73 trillion of income and paid \$142 billion in taxes. Thus, it was estimated that in 1976, 92.6 percent of income from legal sources was reported. The IRS estimated the unreported amount of legal income from various sources as follows:

Individual Income 1976

(Dollar amounts are shown at the midpoint of ranges estimated by the IRS.)

	<u>Billions of Dollars</u>		<u>Percent</u>
	<u>Reported</u>	<u>Unreported</u>	<u>Unreported</u>
Salaries and wages	\$ 881	\$ 24	2.6%
Dividends and income from subchapter S corporations	25	3.5	12.3
Interest	49	6.5	11.7
Capital gains	19	4	17.4
Self-employment	60	36	37.5
Rents and royalties	6	4.5	42.9
Pensions, annuities, estates, and trust	27	5	15.6
Other	<u>7</u>	<u>2.5</u>	<u>26.3</u>
Totals	\$1,074	\$ 86	7.4%

This table indicates that in all categories other than salaries and wages, \$193 billion was reported, but \$62 billion, or 24.3 percent, was not reported. When this 24.3 percent unreported is compared to the 2.6 percent of salaries and wages unreported, it is easy to see the significant effect of withholding. As would be expected, some of the above estimates are more reliable than others. Jerome Kurtz, at that time commissioner of internal revenue, indicated to our task force that the interest and dividend figures were quite firm, whereas the self-employment estimate was rather soft.

These estimates were derived from several data sources. The Taxpayer Compliance Measurement Program (TCMP) provided information on the nature and extent of compliance, using stratified random sampling of returns filed. Discriminant analysis was employed to divide taxpayers into ten classes, each of which had a distinct compliance profile. Selected returns were examined for compliance, and data were weighted appropriately to obtain summary statistics. Data on nonfilers were obtained from the Exact Match File (23), which had been developed from interviews of 50,000 households. This program was directed toward nonfilers having substantial tax due, and thus did not include nonfiling taxpayers with smaller incomes. Other information from a file on employee compensation permitted estimation of the amount of nonfiler wage income. Total income received by individuals was compared with total income reported on tax returns using macroeconomic data from the Bureau of Economic Analysis.

In the previous table, no attempt was made to distinguish between underreporting and nonfiling because of the limitations of the data.

These sources provided only the beginning points for many of the estimates made in the study. As noted earlier, some types of information are more reliable than others. For example, information on income subject to withholding is of a higher quality than that on rents and royalties.

Some preliminary figures on the "Gross Tax Gap" were released in March 1982 as part of Commissioner Roscoe Egger's statement before the Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service. These figures are included here to illustrate the growth in the underground economy. It should be noted that these 1982 figures report unpaid taxes, whereas the 1976 table reflects unreported income. The 1982 report covers income tax only and does not include social security or unemployment taxes, which would undoubtedly be large amounts. The 1982 study also covers the illegal sector for which the estimated tax gap was in the range of \$6.1 billion to \$9.8 billion in 1981.

Some reports issued during the fall of 1982 indicated that the earlier measures of the informal economy might have been substantially overstated. However, as stated before, we have not attempted to measure the magnitude of the underground economy nor do we endorse the methodologies or results of any of the studies. All of the studies indicate that this is a serious problem that needs prompt attention.

Gross Tax Gap From Individual Income Tax Returns Filed, Nonfilers, and
Corporate Tax, Tax Years 1973, 1976, 1979, and 1981

	Amount of Tax Gap (Billions of Dollars)			
	<u>1981</u>	<u>1979</u>	<u>1976</u>	<u>1973</u>
<u>Individual Tax</u>				
Tax loss from underreported income:				
Wages	\$ 2.5	\$ 1.8	\$.7	\$.6
Tips	2.3	1.7	1.4	.9
Dividends	3.6	3.1	1.5	.9
Interest	4.1	2.9	1.3	.9
Capital gains	9.1	8.5	5.1	2.0
Nonfarm business	26.2	17.5	11.6	9.6
Farm business	1.4	1.7	1.7	1.5
Pensions	2.8	2.3	1.1	.7
Rents	1.5	1.2	.6	.4
Royalties	1.3	.8	.4	.1
Partnerships	5.5	3.1	2.5	1.5
Estates and trusts	.5	.4	.3	.2
Small business corporations	1.7	1.2	1.2	.4
State income tax refunds	.4	.3	.1	.1
Alimony	.1	*	*	*
Other	<u>3.1</u>	<u>2.4</u>	<u>1.0</u>	<u>.6</u>
	\$66.1	\$49.0	\$30.6	\$20.5
Tax loss from overstated deductions, and credits**	\$12.3	\$ 9.4	\$ 6.2	\$ 4.8
Nonfilers**	<u>4.9</u>	<u>3.4</u>	<u>2.2</u>	<u>1.2</u>
Total individual tax gap	\$83.3	\$61.8	\$39.0	\$26.5
<u>Corporate Tax**</u>	<u>3.9</u>	<u>4.7</u>	<u>3.6</u>	<u>2.8</u>
Total tax gap from legal sector	<u>\$87.2</u>	<u>\$66.5</u>	<u>\$42.6</u>	<u>\$29.3</u>

*Less than \$100 million

**These are preliminary IRS figures and have not been reviewed by the Office of Tax Analysis.

Note: Details may not add to totals because of rounding.

THE NATURE OF UNDERGROUND INCOME

It is clear that some types of income are more easily understated or omitted from a tax return than others. Thus, the underground economy thrives on income not subject to withholding or to informational reporting. Currency transactions are easier to hide from the tax collector than business conducted with checks. Both currency and checks are more susceptible to underreporting than are credit card transactions. Barter transactions bypass all records—currency, checks, and credit cards—and are the most difficult to detect.

A barrage of articles in the popular media have identified a wide variety of underground activities, ranging from the very small to the very large, such as—

- o Skimming, including businesses that simply fail to record some of their cash sales, cab drivers who leave a few fares off the trip sheet, and merchants who take home television sets and write them off as shoplifting.
- o Tips that are pocketed tax-free.
- o Domestic help paid in currency.
- o Wage earners who moonlight in second jobs and are paid in currency.
- o Building tradesmen or auto mechanics who do extra jobs on their own time.
- o Professionals who exchange services.
- o Business travelers who "pad" expense accounts and do not report reimbursements as income.

- o Unemployed workers or social security retirees who do odd jobs for cash while drawing benefits.
- o Taxable use of business property and other taxable perquisites of business executives.
- o Income that is paid directly into a foreign bank account.
- o Garage sales and flea markets.
- o Arts and crafts sold by the maker.
- o Exchanges of goods or services through one of the many barter clubs or barter exchanges that have sprung up in recent years.

A number of articles in the popular media reveal a lack of understanding of the tax law and the tax system. Some writers fail to distinguish tax avoidance from tax evasion. They appear to condemn all wealthy taxpayers and businesses who avail themselves of the tax incentives intended by Congress to encourage precisely those activities in which the businesses are engaged. A Washington Post article, (18) included as an underground activity any business incorporated in a Caribbean tax haven to avoid U.S. taxes. While such articles may be inappropriate and unfair, they may indicate a public perception that is nurturing the underground economy. The belief that big businesses and the wealthy are avoiding taxes may influence individuals to rationalize their own do-it-yourself tax loopholes.

Some of the underground activities listed previously can produce cash with little or no taxable income. For example, garage sales are often mentioned as part of the underground economy; however, the sale of furniture, clothing, and other household items seldom gives rise to a recognized gain. Other than relatively valuable items—such as

jewelry, sterling silverware, antiques, or art objects—few personal assets are likely to be sold for a price in excess of their original cost. Even in underground sales where the transaction is of a taxable nature, the taxable income is not the full cash received but only the excess over the adjusted basis of the property sold. While the sale of certain items may result in taxable gain, the sale of others may result in nondeductible losses. This generates a perception of unfairness that may cause some gains to go unreported.

Another segment of the underground economy that may not generate much taxable income includes part-time work and work for very low wages. The allowable exemptions and the standard deduction have increased the tax threshold to a point where much of the income from part-time student help, domestic workers, migrant workers and other farm employees, and many tips would not create a tax liability. The underreporting of such income is not to be condoned, but its importance must be viewed in perspective to the total underground economy. This is not to suggest that all small amounts be ignored. Small amounts on many returns can add up to significant revenue losses for the government.

Bartering

Bartering presents especially troublesome enforcement problems and may be one of the most rapidly growing areas in the underground economy. It covers a wide range of transactions—from neighbors exchanging baby-sitting or other favors, to doctors and dentists trading their professional services, to airlines exchanging otherwise

unused spaces on planes for otherwise unused rooms in hotel chains. A relatively new phenomenon, the barter exchange allows individuals or corporations to provide merchandise or render services in exchange for bookkeeping credits. Those credits can be used at a later time to obtain any of a wide variety of goods or services advertised in the barter exchange catalog.

Bartering presents economic and accounting issues, as well as income tax problems. There are unresolved questions about the definition of income and about timing and valuation. Services exchanged among family, friends, and neighbors are probably gifts and therefore not subject to tax. In a direct exchange, the timing is certain although the valuation may not be. The Internal Revenue Code stipulates that income received in a form other than cash is to be reported at fair market value. But, this is often difficult to apply. What is the fair market value of a large block of otherwise unused space on several hundred airline flights? In a direct exchange between two parties, the valuation problem is often somewhat alleviated because value may be more readily apparent on one side of the transaction than on the other. However, the organized barter exchanges may exacerbate the valuation problem by postponing one side of the transaction.

Transactions through a third-party barter exchange also give rise to some technical timing problems. The basic question is whether gain should be recognized for tax purposes when credits are received from the barter exchange or at some later date when actual goods or services are received for those credits. An accrual-basis taxpayer would report income at the time the services are rendered or the merchandise

delivered. A cash-basis taxpayer, on the other hand, might reasonably expect to report income when goods or services are received. It is not certain that barter credits will ever be exchanged for goods or services, and typically there is no provision for refund for unused credits. Nevertheless, the IRS has ruled that barter exchange transactions are taxable at fair market value at the time that goods or services are rendered in exchange for credits (19).

POSSIBLE CAUSES OF UNDERREPORTING

By definition, the underground economy is susceptible neither to precise measurement nor to definitive analysis. Although it is difficult to discern exactly why more and more people are participating in the underground economy, several contributing factors can be identified.

1. The combination of high tax rates and high inflation can cause taxpayers to find themselves with a lower real income, yet a higher tax bill. Otherwise law-abiding taxpayers may reason that their tax burden has risen above their "fair share."
2. The increasing complexity of the tax law can erode public confidence that the tax law is treating everyone fairly. The uneasy, perhaps even subconscious, feeling that others are escaping tax can be used as a rationalization for cutting a few corners.
3. Closely related to, and a substantial cause of, the complex tax law is the use of the Internal Revenue Code to motivate or impede certain social and economic activities. What Congress intends as a tax incentive may be perceived as a tax loophole by some who are not in a position to utilize that particular provision. The perception that Congress is intentionally allowing wealthy taxpayers and big business to escape taxes legally can be a strong motivation for others to create their own tax savings.

4. The increasing media attention to this problem may turn into a self-fulfilling prophecy. It becomes easier to rationalize tax cheating on the grounds that "everyone else is doing it."
5. The changes in social mores and general morality that have been evident in many walks of life also have had an impact in the tax arena. Many people seem to have less confidence in, and respect for, many of society's institutions, including government, the church, universities, big business, and big labor. There is a growing feeling that it is acceptable to ignore "unfair" laws.
6. There is a growing perception that the IRS enforcement practices are applied in an uneven and inequitable fashion, whereby low- and middle-income taxpayers are harassed over small amounts, while insufficient attention is paid to the wealthy and especially to nonfilers.
7. Increasing government rules and regulations and payroll taxes provide motivation for many businesses to keep employees off the books.
8. A perception—whether correct or not—of widespread waste and inefficiencies in government is often used by some to justify their underreporting.
9. There may well be a lack of understanding on the part of many taxpayers as to —
 - o The fact that underground types of income are taxable.
 - o The risk involved in the failure to report fully.
 - o The serious impact the underground economy can have upon society in general.

EXPERIENCE ABROAD

The underground economy is not a phenomenon exclusive to the United States. It seems to thrive in many, perhaps all countries, regardless of their political or economic systems.

The largest underground economy is believed to be Italy's l'economia submersa, which has been estimated at 30 to 35 percent of the regular economy, or \$43 billion (3). Feige states that the underground economy is smaller in Scandinavian countries, where there is a "social contract" between the government and the citizens, than in Italy, where "respect for authority has been crumbling for centuries" (7). Nevertheless, Sweden is estimated to have a secret economy equal to 10 percent of the national product and a loss of tax revenue equal to 15 percent of the budget (3).

France's travail au noir, may constitute 25 percent of the official economy. West Germany's Schwarzarbeit may equal \$25 billion in untaxed labor income and \$4 billion in lost tax revenues, in addition to uncollected payroll taxes. Britain's fiddling was estimated to be 7 to 8 percent of the national output in 1979, but may now be as much as 15 percent. Less than 10 percent of Thailand's 19 million workers file tax returns, and up to 40 percent of all Argentine business is involved with morochos, or the black money market (3, 17). These statistics indicate that the underground economies abroad are at least as large as in the United States. The problem in Europe has been deemed serious enough for the Organization for Economic Cooperation and Development (OECD) to authorize a study of the legal and administra-

tive provisions pertaining to tax avoidance and evasion in member countries (16).

The reasons given for emergence of sizeable underground movements abroad include —

- o High tax rates or steeply progressive tax schedules.
- o The combination of high tax rates, budget deficits, and inflationary pressures.
- o The high percentage of cash transactions. (One half of Britain's labor force is paid in cash.)
- o The large percentage of workers in agriculture, an activity that traditionally has been kept off the books. (Extensive moonlighting has been a tradition in France.)
- o Deep distrust of government.
- o Government inefficiency.
- o High labor costs, which encourage firms to keep employees off the books to avoid payroll and unemployment taxes.
- o Honest businessmen's feelings that they must join the underground in order to remain competitive.

The number of workers engaged in moonlighting and regular jobs kept off the books continues to expand as individuals and firms struggle to meet inflated costs of living and business expenses. Perhaps 5 percent of Europe's labor force and one third of Italy's (65 percent of the government employees and teachers) are involved in secret employment (3, 22). Because of the minimal and inconspicuous capital requirements, many home and personal services are provided by

moonlighters. It is estimated that one out of eight Britons earns as much as \$2,200 per year from moonlighting, yet efforts to control moonlighting have been unsuccessful in Britain. The same problem has been observed in Belgium, France, and elsewhere.

Even if income is stated accurately, expenses may be overstated or even fictitious. Sales-type levies are often evaded, particularly the value-added taxes, which are "easy to evade, despite myths to the contrary" (17).

Perquisites are considered to be part of the "black economy" in Britain, where consultants may be paid in claret, and a large percentage of the automobiles are owned by firms and valued at only one third of what an independent appraisal would suggest for purposes of imputing income (6). "Friendship prices" and under-the-table exchanges flourish from Thailand to France, as well as in Britain. In Japan, "backdoor admission fees" are paid to universities, and entertainment establishments increasingly evade taxes. In the USSR, the second economy is composed of private producers who must pay bribes to facilitate production of goods and services unavailable from the state (9, 21). The diamond industry successfully evades taxes at all levels of production in many countries (2).

Control measures are largely unsuccessful, but France has launched a publicity drive against unlicensed house painters and artisans. Britain has tried to fine construction firms using unregistered workers, but fines have not successfully curbed this practice (3). It has been suggested that less government supervision and involvement are desirable, that self-policing through VAT and household deductions

for repairs (against imputed income of owner-occupancy) be used, that as much activity as possible be legalized, and that business and employment costs be kept as low as possible (2, 15). Tax treaties should be designed to curb transfers between countries that might result in evasion of tax.

PUBLIC OPINION

There have been several interesting studies of public opinion about the underground economy and tax cheating in general. A Roper study (20) found that a belief that tax cheating is widespread is a stronger motivation for people to engage in bartering than is a belief that taxes are too high. A study conducted for the IRS by CSR, Inc. (4) found that only 13 to 14 percent of the respondents report having interacted with the underground economy, and no more than 17 percent agree with statements that tax cheating is acceptable. However, 27 percent admitted to being less than completely honest, and 9.1 percent stretched the truth a little in filing their 1978 tax returns.

In ranking the relative severity of various crimes, only 58 percent thought that stealing \$500 from the government in taxes was "very serious," compared to 71 percent who thought it a very serious crime to steal \$500 in cash from an employer, 69 percent who would not illegally obtain \$500 in food stamps or welfare payments, and 62 percent who would not countenance stealing \$500 from a giant corporation (4).

In Britain, only 31 percent of those questioned thought it was wrong to avoid tax on income earned in one's spare time (17). A Westat, Inc., study (5) found that noncompliance in the United States is also greater on secondary sources of income. Dollars withheld from the principal salary are considered to be the government's share, while dollars received from a second job or from a hobby in which the taxpayer invests time, material, and labor are regarded by many as nontaxable.

WAYS TO ALLEVIATE THE GROWING PROBLEM

While the underground economy is not susceptible to close scrutiny and detailed analysis, several things can be done to help alleviate the situation. It does seem clear that there is no single "quick fix." It is also unlikely that any two or three minor adjustments will make significant inroads on the problem. Real progress will require the coordinated efforts of Congress, the IRS, and other government agencies, and perhaps a major assist from the private sector. Attempts to educate the general public and reduce its willingness to participate in the underground economy will be more effective if they are initiated and conducted by nongovernmental groups.

Two general strategies have been suggested from time to time as possible solutions. Some say that more and better enforcement by the IRS is all that is needed. Others suggest that simply lowering the tax rates will substantially mitigate the problem. While both may be helpful, it is doubtful that either is a panacea.

Although the consensus both here and abroad is that high tax rates are a major contributing factor in the growth of the underground economy, it does not necessarily follow that reducing tax rates will cause the problem to disappear. Individuals who were motivated to find creative ways to avoid 70 percent tax rates may well continue those activities to avoid 50 percent tax rates. The underground economy seems to thrive in most countries around the world, regardless of whether their tax rates are higher or lower than ours.

Enforcement Activities

The IRS has estimated that a revenue agent can produce as much as \$20 for every \$1 of cost. More and better enforcement is, undoubtedly, needed and desirable. However, no one knows or can predict the level of enforcement that would be necessary to change the underground situation appreciably; and even if it were known, it is not certain that the IRS could attract enough good professionals to reach that level of enforcement, given the existing shortage of such individuals. Given the trend toward earlier retirement ages, the IRS should consider recently retired CPAs and other business executives as a new source of qualified personnel. However, it is important to consider what level of government surveillance and investigation the American society is willing to accept. At what point might the cure become more oppressive than the disease?

The IRS can improve its effectiveness by reallocating some of its present enforcement personnel and efforts. Many tax practitioners around the country feel that too much time and effort are being devoted to unproductive trivia when they could be applied to the underground economy. Even with improved efficiency, however, it seems apparent that the IRS will need additional personnel if it is to have much impact on the underground economy.

As one step, Congress should authorize additional resources for the IRS with the mandate that these resources be used on the underground economy. While the mood of the country today seems to favor smaller federal budgets and less government interference, it is likely that the large majority of citizens who are filing properly

would welcome increased surveillance of those who are underreporting. Although reduced federal spending may be generally desirable, an increase in the IRS's budget will normally produce a reduction in the federal deficit.

Penalties

The Economic Recovery Tax Act of 1981 increases the penalties for failure to file informational returns from \$1 per return and a \$1,000 maximum to \$10 per return and a \$25,000 maximum. This is an important step in the right direction, but we also recommend the following changes in penalties. For more than twenty years, the maximum penalty for criminal fraud has been \$10,000 per count. Whatever deterrent value this provision may originally have had has seriously eroded due to the declining value of the dollar. The \$10,000 amount should at least be adjusted for inflation. The penalty for civil fraud should be changed from 50 percent of the total tax due to 100 percent of the tax due on the fraudulently treated items.

Many years ago, certain penalties were waived for individuals who voluntarily corrected prior underpayments. The state of Illinois proclaimed a two-week moratorium from December 28, 1981 through January 8, 1982 during which time criminal penalties were waived for taxpayers who voluntarily paid back taxes (1). Such payments were still subject to interest and civil penalties. It has been suggested that taxpayers who availed themselves of the Illinois moratorium may have created problems for themselves at the federal level. The Treasury Department should consider cooperating with states in a

program to encourage voluntary "catching up." It might be more effective to waive both criminal and civil penalties in such cases, but it does seem reasonable that interest continue to be charged. To the extent that the government already waives penalties in instances of voluntary disclosures, this policy should be publicized.

Informational Reporting

History has shown that the level of compliance improves when the individual knows that the IRS has, or will have, information about the transaction or activity. The IRS receives information from a variety of sources, including the various Form 1099s; informational schedules on tax returns, such as the partnership and the subchapter S schedule Ks; and answers to questions on the many types of tax returns.

Presently, anyone in a trade or business is required to file a Form 1099NEC for certain types of payments in excess of \$600, but only if those payments are made to individuals. Such reporting should be extended to include payments made by businesses to corporations, since many individuals and other small businesses have incorporated in recent years. If this produces an unwieldy flood of paper to the IRS or an unreasonable burden on the business community, a higher threshold might be adopted. For some time, copies of all 1099s have been supplied to the government but not necessarily to the recipient of the payment. ERTA now requires copies to be supplied to the recipient as well, as is presently required for 1099s filed for interest and dividend payments. If the taxpayer is aware that a Form 1099 has been filed, he is more likely to declare the payment as taxable income.

It is impractical and unreasonable to require taxpayers to attach copies of all 1099s to the tax return, as presently required for W-2 withholding statements and interest and dividend receipts that exceed a certain threshold. However, the \$600-type payments usually are included in a gross income figure so that any matching by the IRS is virtually impossible. Requiring a list of such payments in excess of some reasonable threshold would be one possible means of facilitating such matching. At the very least, the total of all 1099s received should be reported as a separate item on the tax return.

California has adopted a requirement that anyone claiming a rent credit on the state income tax return must provide the name and address of the landlord. The federal government has a somewhat similar requirement for taxpayers claiming a credit for child or dependent care. This requirement should be extended to include other credits, such as the energy credit, for payments above a reasonable threshold.

The Federal Reserve Board requires that banks report certain large deposits or withdrawals of cash, but it is our understanding that this requirement is generally ignored. The tax authorities should either initiate their own reporting requirement or prevail upon the Federal Reserve Board to enforce the current requirement more vigorously. All businesses should be required to report cash transactions in excess of some reasonable threshold, such as \$3,000 or \$5,000.

States should be required to provide the federal government and the taxpayer with an informational 1099 on refunds of state taxes.

A system should be devised for reporting by the organized

bartering exchanges. They might be required to report all of the credits issued to their members, or to report all transactions above a certain threshold. Similarly, some of the typically cash businesses such as auction houses, art galleries, and dealers in collectibles and rare metals might be required to report cash transactions above a reasonable threshold.

Several factors of informational reporting must be considered. The benefits are both real and psychological; real in the sense that the matching process can reveal the underreporting of income, and psychological in the sense that the taxpayer who knows that an item has been reported to the IRS is more likely to include it on the 1040. Both benefits are reduced, however, if the IRS does not have sufficient manpower to match and follow up on the information received.

Withholding

As indicated by the 1979 IRS study (14), the level of voluntary compliance is greatest when tax has been withheld at the source. That study also confirmed that the level of compliance is quite poor for self-employment income. An important portion of such income is earned by independent contractors. In 1979 the Executive Committee of the AICPA Tax Division "approved support of the concept of withholding tax from payments to independent contractors, subject to limitations and exemptions no less extensive than those recommended at that time by the Treasury Department" (Minutes, Federal Tax Division Executive Committee, July 17, 1979). This 1979 action was related to the question of differentiating and defining employees and independent

contractors. However, such withholding could raise the level of tax reporting by independent contractors. In February 1982, the Federal Tax Division Executive Committee endorsed the concept of withholding on business payments to independent contractors, with two important caveats. It does not seem feasible to expect withholding by individual households; thus, this requirement would not apply to activities such as home repairs. Secondly, it must be recognized that a payment to an independent contractor becomes a part of gross income, whereas the eventual tax liability is computed on net income. Therefore, the withholding rate should be kept quite low—perhaps 3 to 5 percent. Even at a relatively low level, the withholding would be an important factor in assuring that the contractor will include the payment in reported income.

It has often been recommended that interest and dividend payments should be subject to withholding. If the level of compliance could be raised to that achieved on salaries and wages, the government would collect some \$2 billion to \$4 billion more in income taxes based on the 1979 IRS study (14). In addition to this increased revenue, such withholding might be an important factor in improving the image of equity in the tax law, since many wage earners feel that investors also should be subject to withholding.

Withholding on interest and dividends has been discussed extensively and has been considered seriously by Congress from time to time. Strong objections are raised—primarily on the grounds that it would be unfair to those who will not owe as much tax as is withheld. Furthermore, it is assumed that those individuals will be required to

wait up to eighteen months to get a refund of the over-withheld tax. Some proposals attempt to overcome this problem by providing that low-income individuals and exempt organizations could file a statement with each company indicating that less tax should be withheld. This procedure would overcome the first objection, but would impose serious administrative burdens on both the payors and the payees. The payee would need to file a certificate with every payor—perhaps ten, twenty, or more corporations. New forms would have to be filed for every new investment, even for those that might be in place for a few weeks or a few days. Payors would be required to match these forms with the investors' names and to withhold at varying rates for different payees. Thus, we reject, as unreasonable and unworkable, any graduated withholding system for interest and dividends similar to the system presently in place for wages and salaries.

We do agree that in the interests of equity and maintaining the federal revenue, some form of withholding on interest and dividends is desirable. Innovative thinking is needed to find a system that can minimize the administrative burdens on both payor and payee and also minimize any economic hardship on the payees. It would be helpful if Congress and the major groups of payors and payees would work toward devising a viable system rather than simply objecting to any suggestion of withholding. We recommend that various approaches such as the following be studied and tested.

One system would shift almost all of the administrative burden to the IRS. A flat rate specified by Congress, perhaps 5 to 10 percent, would be withheld by every payor from all dividends and interest.

Eligible individuals and exempt organizations would need to file only one exemption certificate—with the IRS. The IRS would then refund the appropriate amounts on a quarterly basis. In essence, this would entail a deferral of 5 to 10 percent of interest and dividends for three to six months by those who would not owe the full 5 to 10 percent tax. After the initial deferral period, the level of income would be approximately the same as if there were no withholding. This would add a considerable burden to the administrative duties of the IRS, but it would be less than the total burden otherwise borne by the millions of payors and payees.

While the above suggestion should correct the major problems of a comprehensive graduated withholding system, it would create new problems, such as—

- o The IRS would get a single exemption certificate from each payee but would have to match that with reports from payors in several different IRS regions. A quarterly refund may not be feasible.
- o If the IRS did refund any excess withholding during the year, the investor would still receive a report from each payor at the end of the year indicating that tax had been withheld. All of this withheld tax would not yet have been refunded, and the taxpayer might be confused as to whether a credit should be claimed on the 1040 for some or all of the withholding.

If the flat rate withholding is held to a relatively low level—say 5 percent—refunds may be due to only a small proportion of investors. It might be reasonable to ask those investors to wait

until the end of the year to get their refunds on the basis of the regular filing. This suggests at least two additional plans for consideration:

1. Withhold 5 percent from all dividends and all business interest payments and provide refunds at the end of the year to exempt organizations and to those payees who owe less than the 5 percent tax.
2. Allow exempt organizations to file exemption certificates with each payor who would then withhold the flat 5 percent from all other dividend and interest payments. Refunds would be at the end of the year.

In any system that provides for refunds after the end of the year, it might be feasible to require the government to pay interest from the end of the year in order to help alleviate any financial burden on the payees. A 5 percent flat-rate withholding should obviate one of the perceived administrative hardships. The taxpayers should not be required to attach withholding certificates. A listing of all interest and dividends should be sufficient.

If a viable system cannot be found to substantially reduce the administrative costs to the payors, another approach might be to allow the payors a tax credit to offset some or all of those costs.

If an acceptable comprehensive withholding system cannot be found, the IRS might identify particularly troublesome situations and impose withholding only in those areas. For example, if compliance is especially poor on taxable coupon bonds, income tax could be withheld from those interest payments. Institutions presently apply with-

holding on a selective basis (such as on nonresident aliens) and should be able to apply it to specific types of bond issues.

In February 1982, the Executive Committee of the AICPA Federal Tax Division endorsed the concept of withholding at the source of interest and dividend payments provided that either the administrative burden be shifted to the government or the cost of such withholding be borne by the government.

Tips are another source of income that is seriously underreported. The IRS estimates that only about 16 percent of tip income is reported. The IRS has made many studies and has estimated the normal percentage of tip income in various types of establishments. These estimates have been accepted and upheld by the courts in several cases. However, even with these successful efforts, it seems clear that the usual enforcement techniques are not likely to be economically viable due to the large number of individuals involved and the relatively low amount of tax per individual.

Various approaches used in the past have not been effective from an enforcement point of view. Other methods that have been proposed from time to time have been subjected to severe criticism from the businesses and the employees who would be affected. If the various interested parties could be brought together to explore some innovative ideas, perhaps a mutually agreeable solution could be found. It would seem preferable for such a meeting to be sponsored by an organization that is not directly involved in the issue.

As an independent party, the AICPA Federal Taxation Division should invite representatives of the various industries and employee

groups to come together to find an acceptable approach. These interested parties should come realizing that this is a serious problem for which a solution must be found. The group should explore any and all approaches to the problem. New and innovative ideas are needed. Two such ideas that should be explored are suggested here, but all parties should attempt to come up with as many others as possible.

A low, flat rate tax could be collected from hotels, restaurants, airports, or other establishments where tips are common. The establishments could then be authorized to withhold or otherwise collect the appropriate amounts from the employees.

The income of establishments could be grossed up to include the estimated tip income of the employees. A deduction would be allowed for the amounts reported as employee compensation. This approach also might incorporate a withholding mechanism.

The IRS 1982 study shows that the tax gap on pension income is growing much more rapidly than the total gap. This trend is likely to continue as larger numbers of taxpayers receive pensions from a larger number of plans. This is a confusing area for many taxpayers because social security is tax-free, and varying amounts of many other pensions represent tax-free return of capital, while many pensions are 100 percent taxable.

Presently, pensions are subject to informational reporting on Form 1099R. The pensioner may request withholding at the source. We recommend that all taxable pension payments be subject to a modest (say 10 percent) flat rate withholding tax with the pensioner having two options:

1. Withholding at a higher rate

2. Exemption from withholding if it can reasonably be expected that no tax will be due

Currency Reform

There is another long-range approach that we have not seen discussed anywhere else. Although it is removed from the tax arena, intuitively it would seem to be worthy of consideration as a possible deterrent to the underground economy. The vast majority of transactions in the underground economy, other than bartering, are conducted with cash. In the modern world of computers and other electronic devices, there have been suggestions from time to time that modern technology may eliminate the need for cash. Credit cards, electronic fund transfers, paying bills by telephone, and shopping via cable television have all been suggested as the "wave of the future." It might be worthwhile for the government to take steps to encourage those developments and hasten the day when we might need little or no currency in circulation.

An experiment along these lines that the government might try in the near future would be to withdraw from circulation all bills larger than the \$50 bill. In a widespread but completely unscientific survey of people in the business community, we have found no evidence that any legitimate economic activity would be seriously disrupted if there were no \$100 bills in circulation. Yet, the number of \$100 bills in circulation has increased far more rapidly than any other denomination. If it can be presumed that most of these bills find their way into both the informal and the illegal segments of the underground

economy, the absence of such currency could be a deterrent to those activities. If it is deemed necessary or desirable to have \$100 bills in our currency system, an approach used in Switzerland might be used to produce some of the same benefits. Under the Swiss system the \$100 bills, and perhaps the \$50 bills, would expire periodically. Anyone holding such currency would be required to exchange it at a bank.

Miscellaneous suggestions

The following are additional suggestions that should be considered:

- o States should be required to withhold from payments to lottery winners above a reasonable threshold.
- o Tax deductions should be denied for cash payments (other than W-2 type wages) above a reasonable threshold.
- o Reporting of capital expenditures, including additions to the basis of residential or other property, should be mandatory.
- o Deduction for the cost of incentives or prizes should be denied if the value is not included in a Form 1099 (such as the prizes awarded to customers who open new accounts).
- o Questions could be added to the individual 1040, Schedule C regarding any bartering or currency transactions.

Educational Programs

Some individuals may underreport income simply because they do not understand that the income should be reported. In addition, even those individuals who know they are underreporting may not understand all the potential consequences to themselves or to society.

Educational programs might be as effective as major increases in enforcement activities and would very likely be more acceptable to society.

The government should increase its education efforts. A concerted effort should be made to counter the negative publicity given the underground economy. More publicity should be given to the number of returns filed, the amount of tax paid, and the relatively high level of voluntary compliance. The IRS should better publicize its enforcement activities and the results thereof. Instructions for the various tax returns, as well as releases to the popular media, could be used to explain that bartering and currency transactions are to be reported. Special efforts could be directed at those groups more likely to be noncompliers.

It is highly unlikely, however, that government educational programs alone will be sufficient. Statements from the government are often considered to be self-serving and are viewed by many citizens with a great deal of skepticism. Any effort to modify society's views toward the tax system and toward responsibilities to society and to government would be far more effective if it were sponsored by groups outside the government. Such an effort would indeed be a major undertaking, requiring the resources of many groups, and it would be far more effective if it were a cooperative venture involving a wide variety of different types of organizations. For maximum exposure and impact, the program should be cosponsored by professional organizations, trade associations, labor groups, and civic organizations.

Such an educational program should utilize all media and should emphasize such points as—

- o The present voluntary compliance system is valuable and should be preserved.
- o The large majority of taxpayers do pay their tax.
- o Most so-called loopholes are really incentives approved by Congress to improve our economic or social structures.
- o The typical underground transactions are indeed taxable, should be reported, and are reported by most taxpayers.
- o The possible consequences of participating in the underground economy include both personal risks and institutional consequences of excessive government enforcement.
- o We cannot "cheat the government"; any underpayment simply adds to the burden of fellow citizens.

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